No. 22,580

IN THE UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

COMMISSIONER OF INTERNAL REVENUE,

Petitioner

v.

PACIFIC MUTUAL LIFE INSURANCE COMPANY,

Respondent

ON PETITION FOR REVIEW OF THE DECISION OF THE TAX COURT OF THE UNITED STATES

BRIEF FOR THE PETITIONER

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I N D E X

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OPINION BELOW

The opinion of the Tax Court (I-R. 127-179) is reported at 48 T.C. 118.

JURISDICTION

This petition for review (I-R. 183-185) involves federal income taxes for the years 1958 through 1961. On December 24 1964, the Commissioner of Internal Revenue mailed to the taxpayer a notice of deficiency, asserting deficiencies in income taxes in the aggregate amount of $318,659.72 for the calendar years 1958 through 1961. (I-R. 9-36.) Within ninety days thereafter, on March 2, 1965, the taxpayer filed a petition with the Tax Court for a redetermination of those deficiencies under the provisions of

Section 6213 of the Internal Revenue Code of 1954. (I-R. 1-36.) The decision of the Tax Court was entered on August 28, 1967. (I-R. 182.) The case is brought to this Court by a petition for review filed on November 17, 1967 (I-R. 183-185), within the three-month period prescribed in Section 7483 of the Internal Revenue Code of 1954. Jurisdiction is conferred on this Court by Section 7482 of that Code.

QUESTION PRESENTED

Taxpayer, a life insurance company, issues a health and accident policy for a term of one year, guaranteeing that it may be renewed from year to year thereafter upon the payment of premiums, the amounts of which will be subject to the determination of taxpayer. The single question here is whether premiums received in respect of such a policy constitute premiums attributable to insurance contracts "issued or renewed for periods of 5 years or more" within the purview of Section 809(d)(5) of the Internal Revenue Code of 1954.

STATUTE AND REGULATIONS INVOLVED

Internal Revenue Code of 1954:

SEC. 809 [as added by Sec. 2(a), Life Insurance Company Income Tax Act of 1959, P.L. 86-69, 73 Stat. 112] IN GENERAL.

*　　　*　　　*

(d) Deductions.--For purposes of subsections (b)(1) and (2), there shall be allowed the following deductions:

*　　　*　　　*

(5) Certain nonparticipating contracts.--An amount equal to 10 percent of the increase for the taxable year in the reserves for nonparticipating contracts or (if greater) an amount equal to 3 percent of the premiums for the taxable year (excluding that portion of the premiums which is allocable to annuity features) attributable to nonparticipating contracts (other than group contracts) which are issued or renewed for periods of 5 years or more. For purposes of this paragraph, the term "reserves for nonparticipating contracts" means such part of the life insurance reserves (excluding that portion of the reserves which is allocable to annuity features) as relates to nonparticipating contracts (other than group contracts). For purposes of this paragraph and paragraph (6), the term "premiums" means the net amount of the premiums and other consideration taken into account under subsection (c)(1).

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(26 U.S.C. 1964 ed., Sec. 809.)

Treasury Regulations on Income Tax (1954 Code):

Sec. 1.809-5 Deductions.

(a) Deductions allowed. Section 809 (d) provides the following deductions for purposes of determining gain or loss from operations under section 809(b)(1) and (2), respectively:

*　　　*　　　*

(5) <u>Certain nonparticipating contracts.</u>

*   *   *

(iv) * * * The determination of whether a contracts meets the 5-year requirement shall be made as of the date the contract is issued, or as of the date it is renewed, whichever is applicable. Thus, a 20-year non-participating endowment policy shall qualify for the deduction under section 809(d)(5), even though the insured subsequently dies at the end of the second year, since the policy is issued for a period of 5 years or more. However, a 1-year renewable term contract shall not qualify, since as of the date it is issued (or of any renewal date) it is not issued (or renewed) for a period of 5 years or more. In like manner, a policy originally issued for a 3-year period and subsequently renewed for an additional 3-year period shall not qualify. However, if this policy is renewed for a period of 5 years or more, the policy shall qualify for the deduction under section 809(d)(5) from the date it is renewed.

*   *   *

(26 C.F.R., Sec. 1.809-5.)

STATEMENT

The material facts as found by the Tax Court are as follows (I-R. 171-173):

Taxpayer, a life insurance company, issued a guaranteed renewable accident and health contract providing disability income benefits which was available to insureds whose age did not exceed 59 years. Under the terms of the policy , the insured was given the right to renew the policy for consecutive periods of one year each to age 65 by payment of the renewal premium for each such term. Taxpayer reserved the right to change the amount of the renewal premium on the basis of its applicable rate tables in effect on the due date, provided, however, that (1) no change was made in the rate tables applicable to the insured's policy unless such change was also made applicable to all policies providing like benefits and renewal rights and in the same rating class; (2) the rating class of the insured's policy was not changed because of any change in the insured's status, such as change of physical condition or occupation; and (3) each renewal premium was to be determined in accordance with the rating class and age of the insured at the date of issue. Taxpayer computed the premium rates on such guaranteed renewable accident and health policies on the basis that the premium would remain level to age 65, the same as it does for a life insurance policy with a term to age 65. (I-R. 173.)

In determining its gain from operations (also referred to as the Phase II tax base), taxpayer claimed a deduction under Section 809(d)(5) of the 1954 Code, based upon the inclusion of premiums received under the above policies in the computation of <u>3% of premiums attributable to nonparticipating contracts issued or renewed for periods of 5 years or more</u>. The Commissioner determined that the contracts in question did not qualify under Section 809 (d)(5) as "contracts * * * which are issued or renewed for periods of 5 years or more" and that the premiums attributable to the contracts accordingly were not to be included in computing taxpayer's Section 809(d)(5) deduction. (I-R. 173-179.) The Tax Court (three judges dissenting) held that the deduction should be allowed. (I-R. 171-181.) The Commissioner thereafter petitioned for review by this Court. (I-R. 183-185.)

SPECIFICATION OF ERROR RELIED UPON

The Tax Court erred in holding that taxpayer's one-year guaranteed renewable health and accident contracts were includable in computing the deduction provided by Section 809(d)(5) of the Internal Revenue Code of 1954 based upon "nonparticipating contracts * * * which are issued or renewed for periods of 5 years or more."

SUMMARY OF ARGUMENT

Taxpayer, a life insurance company, sells a one-year guaranteed renewable health and accident insurance contract. The contract is initially <u>issued</u> for a period of twelve months. The contract is renewable, however, for consecutive periods of twelve months. Taxpayer is free to fix and determine the premium it will charge for any renewal, subject only to the proviso that the renewal premium it charges will apply to all policyholders in the same rating class under the contract. The Tax Court (three judges dissenting) held that such contracts are includable in computing taxpayer's Section 809(d)(5) deduction based on "3 percent of * * * premiums * * * attributable to nonparticipating contracts * * * <u>issued or renewed for a period of 5 years or more.</u>" (Emphasis supplied.)

Plainly, the Tax Court erred. Apart from the fact that the contracts here involved do not qualify under a strict, literal interpretation of the terms of Section 809(d)(5), the controlling of its applicable rate tables in effect on the due date, provided, however, that (1) no change was made in the rate tables applicable to the insured's policy unless such change was also made applicable to all policies providing like benefits and renewal rights and in the same rating class; (2) the rating class of the insured's policy was not changed because of any change in the insured's status, such as change of physical condition or occupation; and (3) each renewal premium was to be determined in accordance with the rating class and age of the insured at the date of issue. Taxpayer computed the premium rates on such guaranteed renewable accident and health policies on the basis that the premium would remain level to age 65, the same as it does for a life insurance policy with a term to age 65. (I-R. 173.)

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Taxpayer, a life insurance company, sells a one-year guaranteed renewable health and accident insurance contract. The contract is initially <u>issued</u> for a period of twelve months. The contract is renewable, however, for consecutive periods of twelve months. Taxpayer is free to fix and determine the premium it will charge for any renewal, subject only to the proviso that the renewal premium it charges will apply to all policyholders in the same rating class under the contract. The Tax Court (three judges dissenting) held that such contracts are includable in computing taxpayer's Section 809(d)(5) deduction based on "3 percent of * * * premiums * * * attributable to nonparticipating contracts * * * <u>issued or renewed for a period of 5 years or more</u>." (Emphasis supplied.)

Plainly, the Tax Court erred. Apart from the fact that the contracts here involved do not qualify under a strict, literal interpretation of the terms of Section 809(d)(5), the controlling fact is that this category of insurance contracts is not what Congress had in mind in enacting this special deduction provision. The legislative history of Section 809(d)(5) makes it abundantly clear that such benefit is restricted to contracts involving the assumption by the company of long-term (defined as five years or more by the statute) unforeseen risks. The purpose of the deduction is to provide an additional cushion for the assumption of such risks. The contracts here do not call for the assumption by the company of any unforeseen, unanticipated risk for more than a one-year period. At that point, through its unilateral right to set renewal premiums, the company is free to increase the premium and thereby shift any unanticipated increased risk which may have developed over the year to the policyholders as a class. The company is never "locked in," in terms of being bound to assume unforeseen risk for a period of five years or more. Accordingly, the contracts here involved do not meet the standard for inclusion in computing the Section 809(d)(5) deduction. No intelligible legislative purpose would be served in differentiating the contracts in dispute from "1-year renewable term" contracts, which the Senate Finance Committee Report expressly stated do not qualify for the benefit sought by this taxpayer.

ARGUMENT

TAXPAYER'S ONE-YEAR GUARANTEED RENEWABLE HEALTH AND ACCIDENT CONTRACTS DO NOT QUALIFY AS "NONPARTICIPATING CONTRACTS * * * WHICH ARE ISSUED OR RENEWED FOR PERIODS OF 5 YEARS OR MORE" AND PREMIUMS ATTRIBUTABLE TO THEM ACCORDINGLY ARE NOT INCLUDABLE IN COMPUTING THE ALTERNATIVE DEDUCTION PROVIDED BY SECTION 809(d)(5) OF THE 1954 CODE

A. The nature and provisions of the insurance contracts involved

There is no dispute as to the provisions of the insurance contracts involved on this review. The contract is characterized as a "Guaranteed Renewable Income Protection Policy." (Ex. 29-AC.) It is available only to persons of 59 years old or less on the issuance date. The policy contract is issued for an initial term limited to 12 months. Thereafter, and prior to the 65th birthday of the insured, the contract may be renewed for consecutive terms, but no term for which it is renewed may be in excess of 12 months. (I-R. 173; Ex. 29-AC.) The pertinent contract provision states (Ex. 29-AC):

> The Insured shall have the right, prior to his 65th birthday, to renew this Policy for consecutive terms each of the same number of months as the Initial Term by payment to the Company of the renewal premium for each such term, which premium shall be due on the first day of each renewal term.

The presence in the contract of the one-year term limitation is illuminated by the next paragraph of the contract (Ex. 29-AC):

> The amount of such renewal premium shall be determined from the Company's applicable table of rates in effect on the due date thereof, and the Company reserves the right to change from time to time the table of rates applicable to premiums thereafter becoming due.

It is apparent that taxpayer, as the insurer, did not wish to bind itself for more than the term of a year to provide insurance coverage for any premium certain. Rather, it preferred to be in a position each year to make a unilateral independent determination as to what it would charge for insurance coverage for that year. As the contract further provides, this independent determination would be made not in respect of an individual insured, but in respect of the holders of the particular policy as a group. 1/ Any long-range, unanticipated risks or costs connected with the block of business represented by the contract would be borne not by taxpayer, but by the insureds as a class (through an increased premium). Taxpayer, at the outset, is bound to the risk for a period of 12 months. After that, however, it is free to adjust or increase the premium.

It is evident, from a practical standpoint, that the unilateral right to fix and increase the annual premium which will be charged gives taxpayer what is essentially the right to force a termination of coverage. If, for its own business reasons, taxpayer found the bloc of business represented by the contract to be unadvantageous, its power to fix the annual premium would be tantamount

1/ Changes in the annual premium would be made as to all insureds in the same rate class. Thus, an individual policyholder would not be selected out for an increased premium; rather, the increase would be shared and carried by all the insureds under the contract in the same rate class. (I-R. 173; Ex. 29-AC.)

to a power to effect a discontinuance of the business represented by the contract. What is crucial here, however, is a simpler point about which there can be no conjecture. Although the policy contract contains the annual renewal provision, such provision, in the context of taxpayer's right to change the annual premium, imposes upon taxpayer no risk beyond the risk involved in coverage for the term of a single year. Taxpayer is free to shift any increase in the risk beyond that point to the insureds as a class under the contract. Such a contract, as we shall now show, is plainly outside the types of contracts, the premiums attributable to which are to be included in the computation of the special deduction provided by Section 809(d)(5) of the 1954 Code, supra.

B. The special deduction provided by Section 809(d)(5) and the requirement that premiums included be attributable to contracts "issued or renewed for periods of 5 years or more"

The determination of the taxable income of a life insurance company is made under a detailed three-phase statutory formula. Sections 801-820, 1954 Internal Revenue Code (26 U.S.C. 1964 ed., Secs. 801-820).[2] Phase I is concerned with measuring its

2/ The formula was established under the Life Insurance Company Income Tax Act of 1959, P.L. 86-89, 73 Stat. 112, Section 2, which extensively revised the method of taxing life insurance companies. For a detailed discussion of the 1959 Act, see United States v. Atlas Ins. Co., 381 U.S. 233.

income from investments and allocating such income between a non-taxable policyholders' share deemed necessary for reserves and a taxable company's share. Section 804, Internal Revenue Code of 1954 (26 U.S.C. 1964 ed., Sec. 804). Phase II is directed at ascertaining the company's income from all sources and is referred to as the determination of gain or loss from operations. Section 809, Internal Revenue Code of 1954, *supra*. Income from all sources, including premium income enters into this latter formula. Gain or loss from operations is arrived at after subtracting certain items for which deductions are provided.[3] One of these deductions is the Section 809(d)(5) deduction here involved.

Section 809(d)(5) provides a special deduction related to the life insurance company's nonparticipating business. A non-participating insurance contract is one wherein the policyholder has no right to participate in the divisible surplus of the company. Section 1.809-5(a)(5)(ii), Treasury Regulations on Income Tax (1954 Code). Nonparticipating contracts are issued by stock insurance companies, i.e., where company ownership is in stockholders who may or may not happen to be policyholders. In contrast, *mutual* insurance companies, i.e., those where company ownership is in the policyholders themselves, issue participating contracts entitling the policyholder to

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3/ Life insurance company taxable income consists of taxable investment income or gain from operations, whichever is the smaller, plus 50% of the excess, if any, of gain from operations over taxable investment income. To this are added certain amounts relating to distributions to shareholders which are taxed under Phase III which is not here pertinent. Section 802(b), Internal Revenue Code of 1954 (26 U.S.C. 1964 ed., Sec. 802).

share in the profits through dividends. Mutual company policyholders expect periodic dividends, and, in order to provide a regular and continuous flow of dividends, mutual companies traditionally charge a higher annual premium than stock companies, subsequently refunding a portion of the premium to the policyholder as a dividend. S. Rep. No. 291, 86th Cong., 1st Sess., p. 22 (1959-2 Cum. Bull. 770, 786). The 1954 Code (Section 811 (26 U.S.C. 1964 ed., Sec. 811)) provides a deduction for all dividends so paid.

The stock insurance companies argued to Congress that this "redundant premium" device, along with the dividend deduction, would give to mutual companies a built-in tax advantage over stock companies. Mutual companies could maintain tax-free a surplus or cushion from year to year which could be used to meet unforeseen contingencies and unanticipated risks. Stock companies, in order to have available funds equivalent to those supplied mutuals through redundant premiums, would have to maintain a relatively larger surplus which would necessarily have to come out of taxable income. The conclusion was that an extra benefit to stock companies should be written into the law to compensate for the benefit which mutual companies would be receiving. H. Rep. No. 34, 86th Cong., 1st Sess., pp. 6-7, 12, 13 (1959-2 Cum. Bull. 736, 740, 744-745. The result was a provision in

H.R. 4245, 86th Cong., 1st Sess., the House bill, providing a special deduction of an "amount equal to 10 percent of the increase for the taxable year in the reserves for nonparticipating contracts."

This provision constitutes what is now the first of two alternative formulae for the deduction set out in Section 809(d)(5). This formula, however, was not satisfactory to all industry representatives. Hearings before the Senate Finance Committee produced testimony by representatives of some stock companies to the effect that an alternative to the above formula would be necessary to prevent discrimination of sorts against some companies. Senate Hearings, Committee on Finance, 86th Cong., 1st Sess., on H.R. 4245, pp. 129-130, 422-423, 614-615, 686-687. Testimony was given to the effect that the need for the "cushion" or "safety margin" urged for stock companies results from the assumption under some types of policies of long-term risk. Although a formula based upon 10 percent of reserves for nonparticipating contracts would provide a cushion for stock companies issuing policies involving assumption of a long-term risk and maintenance of a high reserve, it would fail to provide a cushion for stock companies principally issuing policies involving long-term risk but low reserves. For instance, some policies involve a substantial savings element and require maintenance of a consequent high reserve. Other types of policies involve smaller savings elements or no savings elements at all, and, therefore, smaller reserves. Viewed in that light, a formula based simply upon reserves would not adequately relate to the amount of long-term risk actually assumed by companies which principally issue insurance contracts involving assumptions of long-term risks but maintenance of comparatively low reserves. Accordingly, a statutory alternative based upon premiums on nonparticipating contracts "as to which the company cannot elect to get off the risk" for a duration of five years or more was recommended. Senate Hearings, Committee on Finance, 86th Cong., 1st Sess., on H.R. 4245, pp. 614-615. See also pp. 129-130, 422-423, 686-687. As enacted, Section 809(d)(5) provided an alternative deduction in--

> an amount equal to 3 percent of the premiums for the taxable year (excluding that portion of premiums which is allocable to annuity features) attributable to nonparticipating contracts * * * which are issued for periods of 5 years or more. * * *

The deduction is explained in the Senate Report (S. Rep. No. 291, 86th Cong., 1st Sess., pp. 54-55 (1959-2 Cum. Bull. 770, 810)) in the following manner:

> 5. Deduction for nonparticipating policies.--Policyholder dividends in part reflect the fact that mutual insurance is usually written on a higher initial premium basis than nonparticipating insurance, and thus the premiums returned as policyholder dividends, in part, can be viewed as a return of redundant premium charges. However, such amounts provide a "cushion" for mutual insurance companies which can be used to meet various contingencies. To have funds equivalent to a mutual company's redundant premiums, stock companies must maintain relatively larger surplus and capital accounts, and in their case the surplus generally must

> be provided out of taxable income. To compensate for this, the House bill allows a deduction for nonparticipating insurance equal to 10 percent of the increase in life insurance reserves attributable to nonparticipating life insurance (not including annuities). Your committee has recognized the validity of the reasons for providing such a deduction and has therefore continued it in your committee's version of the bill. However, basing this addition, as does the House bill, only upon additions to life insurance reserves does not take account of the mortality risk factor present in policies involving only small reserves. To overcome this deficiency your committee's amendments provide that a special 3 percent deduction based on premiums is to apply, instead of the 10 percent deduction, where it results in a larger deduction. This is a deduction equal to 3 percent of the premiums for the current year attributable to nonparticipating policies (other than group or annuity contracts) issued or renewed for a period of 5 years or more.

In delineating, for purposes of the deduction, those contracts which qualify as involving long-term risk, Congress set a requirement that a contract, in order to qualify, must preclude the company from getting off any increased risk for at least five years. The Senate, in discussing the minimum five-year requirement, stated (S. Rep. No. 291, 86th Cong., 1st Sess., p. 55 (1959-2 Cum. Bull. 770, 810)):

> The determination of whether a contract meets the 5-year requirement will be made as of the date it was issued, or as of the date it was renewed, whichever is applicable. Thus, a 20-year nonparticipating endowment policy will qualify under section 809(d)(5), even though the individual insured subsequently dies at the end of the second year, since the policy was issued for a period of 5 years or more. <u>However, a 1-year renewable term contract will not qualify, in that as of the date it was issued (or of any renewal date) it was not issued (or renewed) for a period of 5 years or more</u>. In like manner, a policy originally issued for a 3-year period and subsequently renewed

> for an additional 3-year period will not qualify. However, if this policy were renewed for a period of 5 years or more, the policy would qualify under section 809(d)(5) from the date it was renewed. * * * (Emphasis supplied.)

See also Section 1.809-5(a)(5)(iv), Treasury Regulations on Income Tax (1954 Code), supra.

The Senate Report is explicit in stating that a one-year renewable term contract does not qualify for the deduction. A company issuing or renewing such a contract does not undertake, for the requisite five-year duration, any risk of unforeseen contingencies beyond those contemplated in arriving at the premium. The extent of its risk in this respect is no more than one year. After that, and coincident with any renewal, the company is free to increase the class premium, thereby shifting all costs of unforeseen risks to the insureds. The Senate Report, on the other hand, states that a twenty-year nonparticipating endowment policy would qualify for the deduction. This is so because the company under such a policy, binds itself to assume risks incident to unforeseen contingencies for a duration in excess of five years. The company there binds itself to provide the insurance for twenty years at a specified premium which cannot be increased. (See Ex. 30-AD.) When (and if) unforeseen events occur over the course of the long terms covered by the policies, i.e., changes in environmental conditions increasing the death rate of the insureds, it is the company which will have to bear the burden of the increased unanticipated risks. Whereas the company under such policies must absorb any such increased risk, the company under a one-year renewable term policy effectively can pass the burden to the policyholders.

C. Taxpayer's contracts do not bind it to assume unanticipated risks for a period of five years or more and do not qualify for the deduction

The contracts here are simple one-year guaranteed renewable health and accident contracts. Their inclusion in the computation of the deduction sought is precluded not only under the language of the Senate Report, *supra*, but under its avowed rationale. The Senate Report, *supra*, states that the "determination of whether the contract meets the 5-year requirement will be made as of the date it was issued, or as of the date it was renewed whichever is applicable." (P. 55, 1959-2 Cum. Bull., p. 810.) The contracts here are issued for initial term, not of five years or more, but for what is specifically stated to be a twelve-month period. Coincident with a provision entitling the company to set and determine any renewal premium, the insureds are given the right to renew. The contracts, however, are not "renewed for a period of 5 years or more" as of the date of renewal, and this is the date for the five-year determination. Rather, they are renewed as of that date for a twelve-month period. The contracts here thus do not meet the five-year test for qualification.

Moreover, the Senate Report, *supra,* states specifically that a "1-year renewable term contract" will not qualify for the deduction. (P. 55, 1959-2 Cum. Bull., p. 810.) The fact that such a contract is a one-year renewable contract cannot serve to distinguish it out from this classification. One-year renewable contracts, whether guaranteed renewable or not, involve the same infirmity from the standpoint of qualification for the deduction. In neither instance is the company required to absorb all risks (whether anticipated or not) for at least a five-year period. Rather, at the outset, all risks need be absorbed only over a one-year period. If conditions during that year indicate that the risk is greater than anticipated, the company is bound only to the end of the year. Then it merely sets a new premium and passes the cost of that risk to the policyholders as a whole. The fact that the company, in the case of a guaranteed renewable contract, as opposed to one not guaranteed renewable, cannot refuse annual renewal is of no moment. In the first place, it must be recognized that the right to determine and set each annual premium for the policyholders as a class without restriction is tantamount to a right to decide unilaterally whether to continue or discontinue the block of business represented by the contracts. More importantly, it is not the right to discontinue the contracts after one year, but the right to get off unanticipated risk after one year, which precludes the contracts from qualification for the deduction. It is this unanticipated risk over a long term (here set by Congress as a period of five years or more) to which the deduction is directed. Here the company is not bound to that risk for more than a year and has a built-in device, i.e., the unilateral right to determine and raise any renewal premium, which totally and effectively shifts any increased risk beyond a one-year period to the policyholders as a class.

The Tax Court majority opinion (three judges dissenting) found for taxpayer. (I-R. 176-179.) Its brief discussion of this issue does not offer a tenable basis for a holding in taxpayer's favor. Rather, serious confusion in respect of the purpose of the deduction and the requisite five-year requirement is evident.

The majority states that the contracts "imposed substantial limitations on * * * premium changes." (I-R. 178.) This observation is confusing. The only limitations imposed on premium changes are directed toward assuring that any change in renewal premium will not be directed at individual policyholders, regardless of changes in their health, but must be made across the board for all policyholders in the rating class. The effect of these limitations is only to provide for the spreading of the total cost of any increased unanticipated risk among the policyholders as a class. Such limitations, however, in no way change the essential fact that <u>taxpayer</u> does not have to bear the unanticipated risk. Under the contracts, it is able to shift it to the policyholders and, whether shifted to some policyholders or all policyholders, long-term unanticipated risk is nevertheless not borne by taxpayer.

The majority then states that if the contracts in question do not qualify in computing the deduction, "we would be required to hold the same way as to all nonparticipating insurance contracts, even though the policy was issued for 5 years or more." (I-R. 179.) We are at a loss to understand this conclusion. As the legislative history of the formula for the deduction in issue indicates, its purpose was to provide a cushion to companies issuing long-term contracts involving the risk of unanticipated losses. The fact that the insurer would be bound for a long period to absorb unforeseen losses not considered in setting the premium was deemed to justify this additional deduction. The deduction, as the Senate Report, supra, indicates, is available in respect of all nonparticipating policies, excepting some with annuity features (not here relevant) where the company obligates itself to furnish coverage at a guaranteed rate for periods of five years or more. In such circumstances, the company is, in effect, "locked in." If there are unforeseen losses, the company will be bound to absorb them at least for periods of five years or more. These types of contracts include the great amount of regular life insurance contracts. Under such contracts (see Ex. 30-AD) the company is required to furnish coverage for a long period of time at a premium which is set and specified in that contract. The company cannot change or renegotiate that premium every year, but is bound by it. Such contracts which are for periods of five years or more qualify for purposes of the deduction. The company, under the contracts here in question, is able to get off any unforeseen risk after any given twelve months. The contracts here do not meet the five-year requirement. A holding to that effect conceivably cannot require a similar holding as to the great number of contracts, discussed above, which do meet the requirement.

The statements in the majority opinion, discussed above, are indicative of the assumptions which led it into error. At the heart of the error is a failure to recognize that the five-year requirement is not satisfied by any contract merely because it conceivably could be extended over a five-year period. Any one-year renewable term policy conceivably could be so extended, and Congress has specifically stated that such a contract would not qualify for the deduction. Senate Report, supra. The five-year requirement, as the legislative history makes clear, and as we have shown, refers to a period of five years or more wherein the company is going to be forced to absorb all additional costs of unforeseen risks or losses. The contracts here do not satisfy that requirement.[4/] The Tax Court majority erred in allowing the deduction.

Taxpayer made one additional assertion below, not commented upon in either the majority or the dissenting opinion, which requires brief mention here, if only because it is anticipated that taxpayer may raise it again. Section 801 of the 1954 Code is devoted to defining life insurance reserves for purposes of reserve computations

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4/ Rev. Rul. 65-237, 1965-2 Cum. Bull. 231, discussing one-year guaranteed renewable health and accident contracts and the five-year requirement, also holds to this effect.

to be made throughout the insurance sections (Sections 801 through 820, 1954 Code). Section 801(a)(2) provides that reserves for noncancellable life, accident and health policies are to be included in life insurance reserves for purposes of reserve computations. Section 801(e) provides that:

> SEC. 801. DEFINITION OF LIFE INSURANCE COMPANY.
>
> * * *
>
> (e) Guaranteed Renewable Contracts.--For purposes of this part, guaranteed renewable life, health, and accident insurance shall be treated in the same manner as noncancellable life, health, and accident insurance.
>
> * * *
>
> (26 U.S.C. 1964 ed., Sec. 801.)

The alternative formula under Section 809(d)(5) with which we are concerned is not based upon reserves, but upon "an amount equal to 3 percent of * * * premiums * * *." Indeed, as we have shown, the companies which urged the enactment of the alternative formula did so on the ground that the primary formula "10 percent of the increase * * * in the reserves" would not be a satisfactory basis for a formula for all stock companies. Accordingly, the alternative formula has nothing to do with life insurance reserves. Taxpayer nevertheless argued below that the presence of Section 801(e) in the Code requires that its one-year guaranteed renewable health and accident contracts be treated, for purposes of the alternative formula under Section 809 (d)(5), as if they were noncancellable, i.e., as if taxpayer were not entitled to change the premium charged for any annual renewal. Such an assertion would make no sense from the standpoint of the statute, and such an interpretation of the Code would serve no intelligible legislative purpose.

Life insurance reserves are amounts estimated on the basis of experience and actuarial tables which are set aside, and which, with interest thereon, are anticipated to be sufficient to pay off future policy claims. Section 801(d), 1954 Code. Reserves essentially represent provision for what is expected to happen if the insurance coverage does in fact continue. Among the assumptions upon which reserves are based is the expectation that, as the insured grows older, the risk will gradually increase and provision must be made for this. In computing the annual premium which it will charge for a given contract, the insurance company takes these factors into account and figures in the amount necessary to provide an appropriate reserve. If everything goes as expected, the reserves will provide sufficient funds to pay off claims in future years. Because noncancellable health and accident insurance contracts and guaranteed renewable health and accident contracts involve the possibility of long-term coverage and increased mortality risk, reserves for these types of contracts to anticipate such risk are set up. They are akin to those reserves under ordinary life policies in that they are established in basically the same manner and deal with anticipated risk and provision therefor. They are thus treated in the same manner for reserve computation purposes throughout the Code. The fact that reserves so established are all properly treated in one manner for tax purposes does not make a policy which is only guaranteed renewable into a non-cancellable contract for purposes of the alternative formula for the Section 809(d)(5) deduction, which formula has nothing to do with reserves.[5] Section 801(e) applies only to reserves for guaranteed renewable contracts and their use in the computation of life insurance reserves in the various phases of the life insurance company tax. It is not to be used to change somehow the characteristics of a guaranteed renewable contract to make it something it is not so as to qualify for a deduction which its actual characteristics preclude.

CONCLUSION

That portion of the decision attributable to the holding of the Tax Court that taxpayer's guaranteed renewable health and accident contracts are contracts "issued or renewed for periods of 5 years or more," for purposes of Section 809(d)(5) of the 1954 Code, should be reversed

Respectfully submitted,

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5/ Not only is the alternative formula for Section 809(d)(5) not based upon any reserve calculation, but the purpose of the deduction provided by that formula is to deal with unanticipated risk, rather than anticipated risk, which is provided for by reserves.

CERTIFICATE

I certify that, in connection with the preparation of this brief, I have examined Rules 18, 19 and 39 of the United States Court of Appeals for the Ninth Circuit, and that, in my opinion, the foregoing brief is in full compliance with those rules.

Dated:_____________________ day of _____________________, 1968.

____
Attorney

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